

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:RMD:DEN:TL-N-5609-99

SJBarkley

date:

to: Group Manager, Employment Tax Group
Attn: Michael West

from: District Counsel, Rocky Mountain District, Denver

subject: Request for Advisory Opinion

Taxpayer: [REDACTED]

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ISSUE

Whether bonuses paid to employees of [REDACTED] during [REDACTED] are considered amounts deferred under a nonqualified deferred compensation plan that should be taken into account under Treas. Reg. Section 31.3121(v)(2) as FICA wages in [REDACTED].

CONCLUSION

Based on the factual information available, bonuses paid to employees of [REDACTED] in [REDACTED] are not amounts deferred under a nonqualified deferred compensation plan because the employees did not have a legally binding right in [REDACTED] to those amounts under Treas. Reg. Section 31.3121(v)(2)-1(b)(3)(i).

FACTS

During [REDACTED] [REDACTED] paid bonuses to certain management employees in the amount of \$[REDACTED] and originally reported these amounts as wages paid to employees during [REDACTED]. On [REDACTED], [REDACTED] filed Form 843, Claim for Refund and Request for Abatement, in the amount of \$[REDACTED] for a refund of FICA taxes claiming bonuses paid in [REDACTED] in the amount of \$[REDACTED] were fully vested as of the end of [REDACTED] and under Prop. Treas. Reg. Section 31.3121(v)(2)-1(e) should have been taken into account as FICA wages in [REDACTED]. On [REDACTED], after this Claim for Refund and Abatement was filed, Final Regulations were issued under Treas. Reg. Section 31.3121(v)(2).

According to the Form 843 filed by [REDACTED], during [REDACTED], all of the affected employees who received the bonuses in [REDACTED] had FICA wages in [REDACTED] in excess of \$[REDACTED] so that the reallocation of bonuses to [REDACTED] wages results in no additional FICA tax liability in [REDACTED].

The employment tax examiner asked [REDACTED] for copies of any compensation plans in effect during [REDACTED]. The examiner was given a copy of the Annual Incentive Compensation Plan for [REDACTED] and a copy of an Employment Agreement.

Paragraph [REDACTED] of the Annual Incentive Compensation Plan provides that the Board "reserves the right to increase, decrease, or eliminate any and all plan awards if, in the exercise of its business judgment, such modifications would be in the best interests of the Company."

DISCUSSION

The Federal Insurance Contributions Act (FICA) taxes consist of the old-age, survivors, and disability insurance (OASDI) taxes imposed under §§ 3101(a) and 3111(a) of the Internal Revenue Code and the hospital insurance (medicare) taxes imposed under §§ 3101(b) and 3111(b).

FICA taxes are computed as a percentage of "wages" paid by the employer and received by the employee with respect to "employment." In general, all payments of remuneration by an employer for services performed by an employee are subject to FICA taxes, unless the payments are specifically excepted from the term "wages" or the services are specifically excepted from the term "employment." Section 3121(a) of the Internal Revenue Code defines "wages," for FICA tax purposes, as all remuneration for services, with certain exceptions not applicable here. Bonus payments are wages because they constitute remuneration for services. I.R.C. section 3121(a)(1) imposes a dollar limit on the annual amount of wages subject to the OASDI portion of FICA tax. Section 13207 of the Omnibus Budget Reconciliation Act of 1993 repealed the dollar limit on the annual amount of wages subject to the Hospital Insurance (HI) portion of FICA tax, effective for 1994 and later years.

I.R.C. section 3121(v) provides for the FICA tax treatment of nonqualified deferred compensation plans. Under I.R.C. section 3121(v)(2)(A), any amount deferred under a nonqualified deferred compensation plan must be taken into account as wages for FICA tax purposes as of the later of (1) when the services are performed or (2) when there is no substantial risk of forfeiture of the rights to such amount. This special timing rule may result in the imposition of FICA tax before the benefit payments under the plan begin.

I.R.C. section 3121(v)(2)(B) provides a special exclusion (the nonduplication rule) that prevents double taxation. Once an amount deferred under a nonqualified deferred compensation plan is taken into account as wages under the special timing rule, the nonduplication rule provides that neither that amount nor the income attributable to that amount is again treated as FICA wages. Thus, benefit payments under a nonqualified deferred compensation plan are not subject to FICA tax when actually or constructively paid (i.e., under the general timing rule for wage inclusion) if the benefit payments consist of amounts deferred under the plan that were previously taken into account as FICA wages under the special timing rule plus attributable income. The Company asserts that the bonus payments were amounts deferred in [REDACTED] that those amounts should have been taken into account for FICA purposes in [REDACTED], and that all amounts paid in [REDACTED] should therefore not be subject to FICA tax. Because all employees receiving bonuses in [REDACTED] were above the HI wage base for that year, no FICA taxes would need to be paid with respect to the bonus amounts if the bonuses paid in [REDACTED] were in fact deferred compensation earned in [REDACTED].

I.R.C. section 3121(v)(2)(C) provides that a "nonqualified

deferred compensation plan" means any plan or other arrangement for the deferral of compensation other than a plan described in I.R.C. § 3121(a)(5). Treasury Regulations under I.R.C. § 3121(v)(2) provide guidance for determining whether a plan provides for the deferral of compensation. Under Treasury Regulation § 31.3121(v)(2)-1(b)(3)(i), a plan provides for the deferral of compensation with respect to an employee only if, under the terms of the plan and the relevant facts and circumstances, the employee has a legally binding right during a calendar year to compensation and, pursuant to the terms of the plan, that compensation is payable in a later year. An employee does not have a legally binding right to compensation if that compensation may be unilaterally reduced or eliminated by the employer after the services creating the right to the compensation have been performed.

Based upon the facts presented, it is our position that the Company's plan does not constitute a nonqualified deferred compensation plan within the meaning of I.R.C. § 3121(v)(2) and the regulations thereunder. The plan states that the Board reserves the right to increase, decrease, or eliminate any and all plan awards if, in the exercise of its business judgment, such modifications would be in the best interests of the Company. When an employer retains the discretion to adjust or eliminate compensation, employees do not have a legally binding right to plan payments until payment is actually made. If the Company can eliminate a bonus any time prior to payment, then the employees do not have a legally binding right to that bonus within the meaning of Treas. Reg. § 31.3121(v)(2)-1(b)(3)(i). Accordingly, the plan is not a nonqualified deferred compensation plan for purposes of I.R.C. § 3121(v)(2) and is therefore not subject to the special timing rule under section 3121(v). Instead, the general timing rule for FICA taxation applies. See generally Treas. Reg. § 31.3121(a)-2(a). That is true even though all services required to earn the bonus have been performed. Until the bonus is actually paid, the employer has the discretion to reduce or eliminate the payment. Therefore, no deferred compensation exists. See Treas. Reg. § 31.3121(v)(2)-1(b)(5), Example 6. In that situation, the amount of the bonus should be treated as wages in the year in which it is paid.

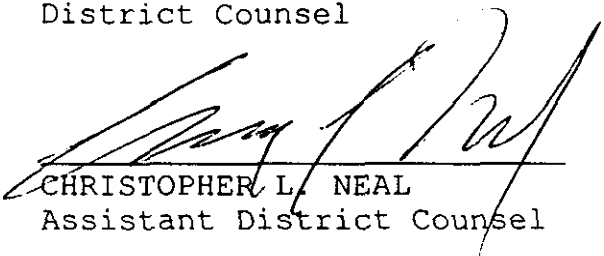
The transition rules in the final regulations under Treas. Reg. § 3121(v)(2) might present a hazard to this case. With respect to amounts deferred and benefits paid before January 1, 2000, those transition rules merely require a reasonable good faith interpretation of I.R.C. § 3121(v)(2), taking into account pre-existing guidance. See § 31.3121(v)(2)-1(g)(2). The payments were made at a time when no guidance under I.R.C. § 3121(v)(2) existed. A court might hold that the Company

reasonably interpreted that a plan in which the employer retained discretion to alter or even eliminate payments was nonqualified deferred compensation within the meaning of § 3121(v)(2). However, our research revealed no guidance under the prior law governing deferred compensation (§§ 3121(a)(2), (3), or (13)) that suggests that deferred compensation is constructively received when the employer has reserved a right to alter or eliminate that compensation.

In conclusion, based upon the available facts, we recommend denial of the claim. If you have any further questions, please call Sara Barkley at (303) 844-2214 ext. 265.

MARTIN B. KAYE
District Counsel

By:



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Assistant District Counsel